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Hello and thank you for the opportunity to speak with you about this critical topic. When states want to spur businesses to create jobs and make new investments, tax incentives are often the primary tool they reach for. Every state has at least one incentive intended to promote economic growth, and most have several. These incentives take several shapes. Some aim to promote economic growth within particular communities. Others seek to grow key industries or types of jobs.

Regardless of these differences, the stakes are high. Policymakers spend billions of dollars a year on tax incentives. Clearly, they don't want to miss opportunities to spark economic growth that will lead to more jobs, higher earnings and brighter prospects for the Americans they serve.

At the same time, policymakers must consider the trade-offs. A dollar spent on a tax incentive is one that they cannot spend on other investments to grow their economy such as education and infrastructure. And, if an incentive is not effective—that is to say, not achieving its intended purpose—then the state may have less revenue over the long run.

These high stakes are what drive our interest in tax incentives at Pew. Across many issues, we have found that government delivers better results when policymakers base their decisions on solid evidence, invest in programs with strong returns on taxpayer dollars, and choose solutions that work over the long term.

With these interests in mind, Pew released two reports last year focused squarely on tax incentives. The first asked: Do state policymakers have the evidence they need to determine whether tax incentives are delivering a strong return? The second asked: Are policymakers effectively managing the fiscal risks of tax incentives?

Grounded in this research, Pew has identified policies and practices that put states in a position to answer "Yes" to both of these questions. We are working with lawmakers and other stakeholders to implement these policies.

I want to talk with you today about our recommendations for making state tax incentives both fiscally sound and economically effective. Then I would welcome your questions and comments.

The overall picture revealed by our research is that lawmakers frequently rely on incomplete, conflicting, or anecdotal information when they make decisions about offering tax incentives. Closing this knowledge gap should be a top priority for policy makers.

But how? Our recommendations fit into two main elements that, together, help states design effective and accountable economic development strategies. First, policymakers need to plan carefully before they approve or expand an incentive to ensure they are fiscally sound.

Second, states need to thoroughly evaluate all of their incentive programs at regular intervals and ensure that the results of these evaluations are considered by lawmakers as they decide whether to renew, change, or end particular incentives.

Has any state mastered these steps? Not yet. But while no state has put all the pieces together, some have set examples that others can learn from. I'll highlight a number of these states as we break down the two elements.

First off, what should states do up front when approving an incentive or changing an existing one? To protect the state budget against unexpected costs, policymakers should have a reliable estimate of the incentive's fiscal impact, and they should set annual limits on the incentive's total cost.

It sounds like common sense—and it is—yet we've found that states use these tools inconsistently. As a result, some tax incentive costs have grown quickly and unexpectedly without any explicit choice by lawmakers to expand them.

In Louisiana, for example, an incentive for natural gas drilling went from costing a few hundred thousand dollars to more than $200 million in the span about four years. These unpredictable cost increases can throw state budgets out of balance and force lawmakers to raise taxes or cut spending on other priorities.

The good news is that cost estimates and annual limits have been used together for a wide range of incentive programs, including Arizona's Quality Jobs Tax Credit, a manufacturing investment incentive in Florida, and Pennsylvania's Film Tax Credit.

Some states have put cross-cutting policies in place that ensure estimates and spending caps are used consistently. Minnesota has taken two noteworthy steps on cost estimates. First, every bill that affects the state's tax collections receives a cost estimate on its final version. In many other states, there is no guarantee that estimates will be updated when bills are amended, meaning legislators may vote on a proposal without knowing how much the latest version will cost.

Second, if the final estimate shows that the tax changes would throw Minnesota's budget out of balance, lawmakers are required to increase revenue or reduce spending elsewhere to make up the difference. In this way, Minnesota's cost estimates link directly to its budget process. In most states, cost estimates are only advisory.

Iowa takes a rare approach to its annual limits on tax incentives. Most states apply caps only to particular incentive programs. In Iowa, the total amount that the state's economic development agency can award, across all its tax credit programs, is subject to one combined cap.

So, by using estimates and annual spending caps together, states can guard against unexpected costs and the difficult choices those expenses can force.

A second key element of a state's economic development strategy is ensuring that evaluations are high quality and connected to the policy process.

States should go beyond collecting and aggregating numbers reported by those receiving incentives. They must rigorously analyze the economic impact.

Pew recommends that state efforts to evaluate tax incentives be guided by four principles.

1) All tax incentives will be reviewed regularly according to a strategic schedule.
2) Evaluations will draw clear conclusions based on measurable goals.
3) Rigorous evaluations will determine benefits and costs.
4) Evidence from evaluations will inform policy choices.

States that design an evaluation process based on these principles give policymakers the facts and opportunities they need to ensure that tax incentives deliver a strong return on investment.

Now I'd like to discuss putting these principles into practice and some of the important policy decisions that arise from each one.

Again, the first principle is that all tax incentives will be reviewed according to a strategic schedule. The key decision point is: How often should tax expenditures be reviewed? Any decision about frequency comes with trade-offs between resources, timeliness, and depth of the analysis. Some ideas for setting an evaluation schedule include:

- Ensure evaluations are ready in time for budget and policy decisions.
- Consider grouping tax incentives with similar goals together, which allows for comparison of effectiveness.
- Allow for flexibility as needs and priorities change.

Our research shows that 10 states have policies requiring regular evaluations of tax incentives. Arkansas, California, and Nebraska perform incentive reviews annually. Delaware examines its incentives every two years, while Connecticut and Rhode Island do so once every three years. Arizona, Iowa, Oregon, and Washington have set a review cycles ranging from five to 10 years.

The second principle is that evaluations will draw clear conclusions based on measurable goals. Such conclusions provide lawmakers with choices that they can consider and act upon.

In Washington, evaluators concluded that an incentive meant to provide temporary relief to the state's beef processors was obsolete. The industry was no longer suffering the consequences of a mad-cow disease outbreak years earlier. Policymakers agreed and ended the program.

Analysts can also draw conclusions about ways an incentive might be improved.

An evaluation of Louisiana's Quality Jobs program pointed out that the rules governing the tax credit allowed employers to claim it while not providing employees the level of health insurance policymakers had intended. In response, Louisiana's Economic Development agency updated the program's rules to require companies to offer better coverage and to provide new employees with coverage within 90 days.

To arrive at clear conclusions, evaluators must ask questions about what the tax incentive is trying to achieve.

Therefore, policymakers need to set clear, measurable program goals—goals that link to a state's economic development strategy and that evaluators can use as a yardstick when determining whether the incentive has worked as intended.

For example, the stated purpose of New Mexico's Laboratory Partnership with Small Business Tax Credit is "to bring technology and expertise of the national laboratories to small businesses in New Mexico to promote economic development in the state, with an emphasis on rural areas."

This goal raises several interesting questions:

- How can we quantify "technology and expertise"?
- What qualifies as a "small business"?
- What economic activity should change, and how?
- How do we define "rural areas"?

The answers to these questions affect how evaluators assess the program and the conclusions they try to reach.

Sometimes, lawmakers' goals are not clear when an incentive is created, or their objectives for an existing program evolve. In these situations, policymakers and program analysts can work together to define or revise goals at the outset of an evaluation process.

When North Carolina's General Assembly commissioned a study of the state's tax incentives, policy leaders worked with evaluators to identify three primary goals: creating quality jobs, benefiting distressed areas, and making the state more economically competitive. Within each of those broad goals, lawmakers and the evaluators identified relevant measures of success.

Selecting measures of success is another important decision point. Each state needs to ask: How will we determine the metrics used in tax incentive evaluations? Here are a few ideas for addressing this question:

- The state can require legislative guidance on goals and metrics for new, expanded, or extended tax incentives.
- A pending bill in the District of Columbia provides an interesting model. The legislation would require the office conducting the evaluation to report the metrics that will be used in the evaluation to the District's legislature before the evaluation is conducted.
- Given the vast number of ways that incentives can be designed, there is no universal set of benchmarks that can be used to determine the success of

every program. So, a comparative approach to benchmarks can be very valuable. With this approach, some key questions to consider include:

- Is the incentive getting better results than its own past performance?
- Is the incentive more effective than other economic development strategies the state is pursuing?

Now, moving on to the third principle: rigorous evaluations will determine the benefits and costs of the tax incentive. Applying this principle means asking and answering critical questions about the economic impact of the incentive.

One important question is: To what extent did the incentive affect the choices businesses made? There is no simple way to isolate the impact of a tax incentive, but a number of states have used creative approaches to get at the answers.

In Oregon, an evaluation of the state's Business Energy Tax Credit developed financial models for projects like wind farms that receive the incentives. The evaluation used the financial models to help determine whether the incentive would encourage an energy project to go forward that otherwise would not have, or when projects were likely to happen without the state's support.

A second question evaluators should answer is: Were existing businesses affected by the incentive?

In Louisiana, businesses benefitting from the state's Enterprise Zone program reported creating a total of 9,000 jobs. But an evaluation by the economic development department found that the new jobs in hotels, restaurants, retail, and health care were mostly displacing existing jobs. After taking this displacement into account, the agency estimated that the program was creating only 3,000 new jobs.

A third issue evaluators should study is the opportunity costs. In other words: Did the benefits of the incentive outweigh the negative effects of the tax increases or spending cuts needed to offset it?

The story of Massachusetts' film tax credit shows why this question is so important. According to an evaluation, the film incentive created more than 1,600 jobs in 2009. But the program's $70 million price tag had to be offset by cuts elsewhere in the budget. The evaluation estimated that these cuts would cost the state more than 1,400 jobs, leaving Massachusetts with a gain of 222 jobs for its investment. The disappointing news didn't stop there, though. A subsequent evaluation, reviewing the film credit's 2010 results, reported a net gain of just 20 jobs.

To help ensure that evaluations can measure economic benefits, there are a few upfront decision points to consider:

- First, who will provide the analysis?
    - Often, states look to a respected, non-partisan office with the appropriate technical capacity.
- Next, how can the necessary data be collected and made available?
    - Data challenges are common, but not insurmountable. In many cases, cross-agency cooperation is necessary.
- Third, what methodologies will be used to measure the economic impact of the tax incentive?
    - As noted previously, there are examples of states that demonstrated creative approaches to tackling these challenging analytical questions.

Finally, the fourth principle: ensuring that evidence and conclusions from evaluations are connected to the policy-making process.

One challenge facing most states is that lawmakers do not routinely review tax incentives. Likewise, after an incentive is enacted, its costs rarely get examined alongside other spending when lawmakers write the state's budget.

Oregon has devised a way to fight this tendency. To encourage regular review of all incentives, state leaders passed a law that makes all tax credits expire after six years unless lawmakers extend them.

And this approach worked. In 2011, legislative leaders set a spending cap on expiring incentives. That drove policy makers to rely on evaluations to make tough choices. They decided which incentives should continue and in what form.

Lawmakers allowed several incentives to expire, extended others for another six years, and significantly reformed one tax credit that had grown to be far more expensive than intended. Notably, these changes received widespread support in the legislature and from the governor; there were only three dissenting votes.

Other models for connecting evaluations to the policy process include Washington State which has a strategy that combines citizen input, expert analysis from the legislative auditor, and annual hearings by legislative leaders.

Iowa and Arizona have special legislative committees that review tax incentives and tax expenditures.

In closing, it is worth noting that momentum to adopt these principles is building in several states.

In July, Rhode Island lawmakers approved the Economic Development Tax Incentives Evaluation Act of 2013, making their state one of the few to regularly measure the benefits and costs of tax credits, deductions, and exemptions meant to grow jobs and businesses.

Rhode Island's law includes requirements to create a strategic evaluation schedule and to produce evaluations that measure the benefits and costs of each incentive and draw clear conclusions. Rhode Island's law also requires that the governor's budget proposal include a recommendation to continue, reform, or end a tax incentive program after each review, connecting evaluations to the policy-making process.

Several other states took steps towards greater evaluation this year. For example:

- Florida adopted a policy that requires state economists to conduct more rigorous studies to see what benefits business tax incentives create.

- And Maine established a Tax Expenditure Review Task Force with a mandate that includes drafting legislation that creates a process for ongoing review of all tax expenditures.

Other states are working to clarify the purpose and goals of their incentives.

- Vermont now requires that all tax expenditures have a statutory purpose; expenditures without a purpose can't be implemented.

Meanwhile, in Washington, all new tax preferences are required to have a 10-year sunset, an explicit statement of legislative intent, and identified metrics to help evaluate their impact and effectiveness.

Pew's goal is to help policymakers master all of the tasks and tools I reviewed today—the tools needed to make tax incentives fiscally sound and economically effective.

We want you and your peers to have the facts you need to design sound policies and to ensure that you are neither missing important economic opportunities nor creating more risk than your budget and constituents can afford.

We are grateful for the opportunity today to share these important lessons and examples with you, and we hope you find these developments encouraging. We look forward to talking with you and your staff about your interests and priorities and how our efforts may contribute to your success.

Thank you.